Country Report

Mongolia

February 2009

The Economist Intelligence Unit
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The Economist Intelligence Unit

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Symbols for tables

“n/a” means not available; “–” means not applicable

Printed and distributed by Patersons Dartford, Questor Trade Park, 151 Avery Way, Dartford, Kent DA1 1JS, UK.

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Summary

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The political scene is set to remain volatile following a violent general election in June. The election was won by the ruling Mongolian People's Revolutionary Party (MPRP), although the opposition Democratic Party (DP) decided to join the government despite disputing the election results. The political scene will continue to be turbulent as the government attempts to cope with the ongoing economic crisis, while also pursuing its main goal of reducing poverty. Real GDP growth will slow sharply in 2009, to 6%, owing to falling commodity prices.

The political scene

The deteriorating economic environment is putting the new coalition government under increased strain. The government has had to amend budget plans for 2009 in part owing to the sharp fall in tax revenue from the mining sector, as copper and gold prices have tumbled. The governor of the Bank of Mongolia (BOM, the central bank), Alag Batsukh, unexpectedly resigned in December, amid concerns over the independence of the BOM.

Economic policy

In November the economic and financial crisis claimed its first victim when the government took over a leading commercial bank, Anod Bank. Credit growth has risen rapidly in recent years, especially to the overheated property sector. In response to the crisis, a number of international rating agencies have downgraded the ratings of local banks. The government ran a fiscal deficit of Tg305.7bn (US$260m) in 2008 (equivalent to 5% of GDP), which was around double the target level.

The domestic economy

National accounts data for Mongolia remains patchy. However, the economy is slowing sharply owing to falling prices for copper (Mongolia's main export), which has hit export earnings and government revenue. Meanwhile, problems in the banking sector have led to a marked tightening of domestic credit, further slowing overall economic growth. Consumer price inflation eased down to 22.1% year on year in December, from a high of 33.7% in August, and an average of 28% for the whole of 2008. The government has still not finalised an investment agreement with a Canadian firm, Ivanhoe Mines, to allow the long-delayed Oyu Tolgoi copper-mining project to get off the ground.

Foreign trade and payments

The merchandise trade deficit widened sharply in 2008 to reach US$1.1bn, compared with a deficit of only US$228.3m in 2007. Foreign-exchange reserves have fallen, amid attempts by the government to defend the togrog.

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Next report: Full schedule on www.eiu.com/schedule

Political structure

Official name	Mongolia
Form of state	Republic
The executive	The Mongolian People's Revolutionary Party (MPRP) won the election held in June 2008, but the result was contested by the opposition Democratic Party (DP). The MPRP was able to form a government only after allowing the DP to join a governing coalition
Head of state	The president, Nambaryn Enkhbayar
National legislature	A single-chamber parliament, the State Great Khural, which has 76 members
National elections	June 29th 2008 (parliamentary) and May 22nd 2005 (presidential); the next elections are due by June 2012 (parliamentary) and May 2009 (presidential)
Main political organisations	The MPRP and the DP

	Prime minister	Sanjaagiin Bayar
	First deputy prime minister	Norovyn Altankhuyag
	Deputy prime minister	Miyegombyn Enkhbold
	Cabinet Office	Nyamaa Enkhbold
Key ministers	**Defence**	Luvsanvandangiin Bold
	Education, culture & science	Yondongiin Otgonbayar
	Environment & tourism	Luimediin Gansukh
	Finance & economy	Sangajavyn Bayartsogt
	Food, agriculture & light industry	Tunjungiin Badamjunai
	Foreign affairs	Sukhbaataryn Batbold
	Health	Sambuugiin Lambaa
	Infrastructure & urban development	Khaltmaagiin Battulga
	Justice & internal affairs	Tsendiin Nyamdorj
	Minerals & energy	Dashdorjiin Zorigt
	Social welfare & labour	Togsjargalyn Gandi

Central bank governor	L Purevdorj
Chairman of the State Great Khural (national assembly)	Damdin Demberel

Economic structure

Annual indicators

	2004[a]	2005[a]	2006[a]	2007[a]	2008[a]
GDP at current prices (Tg bn)[b]	2,152.1	2,779.6	3,715.0	4,557.5	n/a
GDP (US$ m)[c]	1,815.7	2,306.1	3,187.7	3,891.6	n/a
Real GDP growth (%)[b]	10.7	7.3	8.6	9.9	9.0[c]
Consumer price inflation (year-end; %)[b]	11.0	9.5	6.0	15.1	22.1
Population (m)[d]	2.56	2.58	2.60	2.63	n/a
Merchandise exports fob (US$ m)[d]	872.1	1,068.6	1,545.2	n/a	n/a
Merchandise imports fob (US$ m)[d]	901.0	1,097.4	1,356.7	n/a	n/a
Current-account balance (US$ m)[d]	-24.6	-5.1	108.9	n/a	n/a
Reserves excl gold (year-end; US$ m)[d]	236.3	430.3	926.0	1,195.6	n/a
Total external debt (US$ m)[e]	1,360.0	1,380.0	n/a	n/a	n/a
Exchange rate (av; Tg:US$)[d]	1,185.3	1,205.3	1,165.4	1,171.1	1,165.7

[a] Actual. [b] National Statistical Office, *Yearbook*. [c] Economist Intelligence Unit estimates. [d] IMF, *International Financial Statistics*. [e] World Bank.

Main origins of gross domestic product 2007[a]	% of total
Industry	35.7
Mining	27.4
Agriculture	20.6
Transport & communications	9.1
Trade	7.6

Components of nominal GDP 2007[a]	% of total
Private consumption	48.9
Government consumption	15.2
Gross capital formation	37.6
Gross fixed capital formation	34.9
Net exports of goods & services	-1.7

Principal exports 2006[b]	US$ m
Copper concentrate	635.2
Gold & gold products	270.1
Cashmere & cashmere products	143.3

Principal imports 2006[b]	US$ m
Mineral products	446.3
Machinery & equipment, electrical appliances	270.6
Transport equipment, vehicles & spare parts	158.5

Main destinations of exports 2007[a]	% of total
China	74.8
Canada	9.5
US	5.3
Russia	3.1

Main origins of imports 2007[a]	% of total
Russia	35.2
China	31.8
Japan	6.6
South Korea	5.6

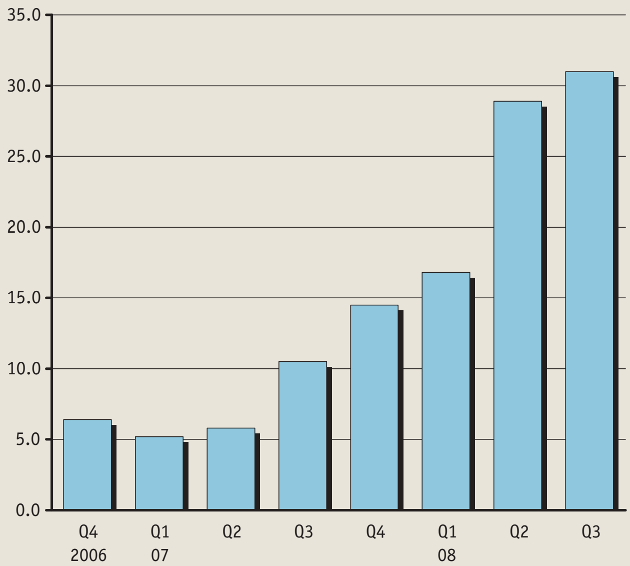
[a] National Statistical Office, *Yearbook*. [b] National Statistical Office, *Monthly Bulletin of Statistics*.

Quarterly indicators

	2006	2007				2008		
	4 Qtr	1 Qtr	2 Qtr	3 Qtr	4 Qtr	1 Qtr	2 Qtr	3 Qtr
Prices								
Consumer prices (2000=100)	146	148.6	153.8	161.1	167.1	173.5	198.2	211.1
Consumer prices (% change, year on year)	6.4	5.2	5.8	10.5	14.5	16.8	28.9	31.0
Financial indicators								
Exchange rate Tg:US$ (av)	1,165.2	1,164.9	1,164.7	1,177.4	1,176.9	1,171.1	1,163.0	1,152.6
Exchange rate Tg:US$ (end-period)	1,165.0	1,165.0	1,163.8	1,184.3	1,170.0	1,168.2	1,158.1	1,146.1
Bank rate (end-period; %)	6.4	4.3	3.7	8.8	9.9	11.3	15.4	16.1
Deposit rate (end-period; %)	13.4	13.5	13.5	13.5	13.4	12.5	10.7	10.5
Lending rate (end-period; %)	20.9	18.9	18.8	15.0	17.5	17.4	18.0	18.4
M1 (end-period; Tg bn)	331.9	401.5	502.2	515.4	590.5	577.7	624.9	603.5
M1 (% change, year on year)	23.3	46.3	52.8	55.6	77.9	43.9	24.4	17.1
M2 (end-period; Tg bn)	1,519.8	1,725.4	1,998.0	2,175.4	2,391.1	2,434.2	2,528.1	2,471.7
M2 (% change, year on year)	30.8	43.1	36.6	42.4	57.3	41.1	26.5	13.6
Foreign trade (US$ m)								
Exports fob	462.6	371.2	465	463.4	589.4	579.8	696.5	692.3
Imports cif	-417.7	-349.1	-519.3	-593.7	-655.2	-645.5	-1,049.5	-1,029.9
Trade balance	44.9	22.1	-54.3	-130.3	-65.8	-65.7	-353.0	-337.6
Foreign reserves (US$ m)								
Reserves excl gold (end-period)	926.0	1,040.6	1,161.8	1,228.5	1,195.6	1,156.2	n/a	n/a

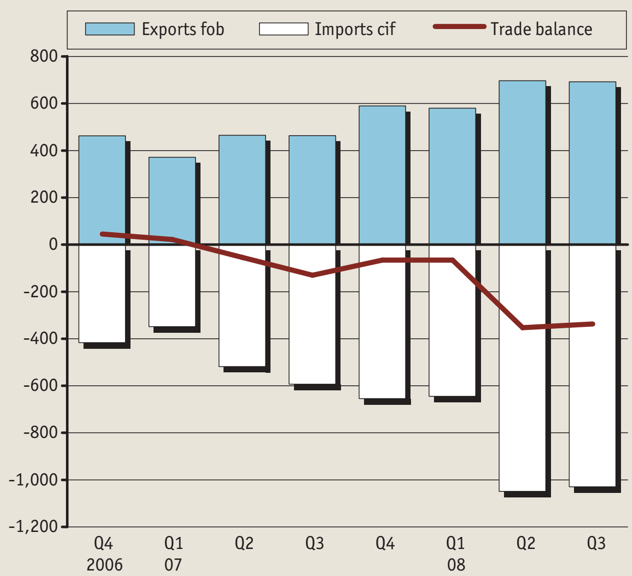
Source: IMF, *International Financial Statistics*.

Mongolia: consumer prices
(% change, year on year)



Source: IMF, *International Financial Statistics*.

Mongolia: foreign trade
(US$ m)



Source: IMF, *Direction of Trade Statistics*.

Outlook for 2009-10

Political outlook

Domestic politics

Mongolia has a relatively short democratic history (its first democratic elections were held in 1992) and its politics can be turbulent, with frequent changes in cabinet members and coalition partners. Most recently, the ruling Mongolian People's Revolutionary Party (MPRP) won the national election that was held in June, but the results were challenged by the opposition Democratic Party (DP), leading to weeks of uncertainty. The DP and the MPRP remained at loggerheads until late August, when the two sides agreed to form a coalition government, with the DP as junior partner. A new cabinet was then formed, led by the MPRP's Sanjaagiin Bayar as prime minister.

The prospects for stability within the latest coalition may not be high, given that some within the DP felt that the party should have remained outside of the government and continued to contest the election result. Mongolia's fragile new coalition government has already faced a difficult few months, with a sharply deteriorating economy necessitating a bailout of the banking sector in November. Despite the prospect of a widening budget deficit in 2009, the government is planning to maintain much of its social welfare spending programme. However, a further fall in revenue could heighten disagreement among coalition members faced with making difficult and unpopular decisions over budget cuts. The run-up to the presidential election in May could also strain relations between the two parties, with both sides expected to field candidates.

The MPRP has a small majority in parliament, which, in theory, allows it to govern without the DP if relations break down. However, without the DP, the MPRP lacks the numbers to make up the quorum needed for parliament to meet. The DP therefore retains a limited amount of bargaining power; if relations deteriorate sharply, the DP could stage another boycott of parliament, as it did following the election.

In the run-up to the election the government took a more nationalistic stance on foreign investment in the mining sector. It decided to review the 2006 mining law and delay the approval of a massive Canadian-funded project, the Oyu Tolgoi copper and gold mine. The government appeared to have bowed to public sentiment that foreign investors are benefiting from over-generous deals. By late 2008, with the economy slowing sharply, the government clearly felt under renewed pressure to push this and other mining deals forward. However, it will remain wary of offering too generous a deal, for fear that it could stir up nationalist sentiment and encourage protestors to take to the streets. The risk of protests against rising prices appears to be receding. However, public protests are likely if the government is forced to cut its social welfare programmes owing to declining revenue.

International relations

The government is expected to continue the previous pragmatic approach to foreign policy, reflecting the need for Mongolia to balance the influence of its larger and more powerful neighbours. The main focus of foreign policy will remain the need to balance relations with Russia, on which Mongolia depends for energy, and China, on which it relies as an export market. The government has sought to strengthen ties with both countries and also with what it calls “third neighbours"—countries that are supportive of its young democracy, even if they are not close geographically. The leading countries in this category are the US and Japan, both of which are substantial aid donors and important counterweights to dependence on Russia and China.

Economic policy outlook

Policy trends

The government has had to adjust its policy priorities quickly in the past three months. From a situation of strong growth, high inflation and a budget surplus, the government is now facing a sharp economic downturn. The steep fall in world prices for copper and gold in late 2008 will sharply reduce government revenue from corporate tax and from the mining “windfall” tax. The 2009 budget predicts much lower revenue. Although some adjustments have been made to spending, the government remains committed to its substantial social welfare programme for now, with poverty reduction set to remain a priority. Mongolia is one of the world’s poorest countries: some 35% of the 2.6m population live below the poverty line and the transition to a market economy has widened income disparities. However, without steeper cuts to spending, the budget deficit is expected to widen to at least 6% of GDP this year, from 5% in 2008—a marked deterioration after several years of surpluses.

Another priority for the government is that of stabilising the financial sector and protecting the exchange rate, while also supporting economic growth. In November the government was forced to agree to a substantial bailout package after one of the biggest commercial banks failed. After several years of strong loan growth, much of it short term, the economy is now slowing quickly, creating a deteriorating environment for the banking sector. In early 2009 the government indicated that it was in talks with the IMF and with China about substantial loans in order to help it to endure the crisis. Any loans received are likely to be used to fund the bank bailout, as well as investment programmes designed to support economic growth.

Monetary policy is likely to be loosened in 2009 as the government seeks to encourage lending and support growth. Until September the economy appeared to be on the brink of overheating, with inflation rising steeply. In September the Bank of Mongolia (BOM, the central bank) raised its key policy rate, the second rise in 2008 and the fourth in under a year. However, as inflation slowed and economic conditions began to deteriorate in late 2008, the BOM began to loosen monetary policy. In mid-November the BOM cut the policy rate by 0.5 points, to 9.75%.

One of the most important policy decisions facing the government is how to handle the development of Mongolia’s huge reserves of coal, copper and gold. The scale of these reserves has attracted substantial foreign direct investment (FDI). Once various major projects go into production, Mongolia can expect a leap in exports and in real GDP growth. However, progress has not been smooth. Frequent changes to cabinet members have caused headaches for foreign investors, who have faced repeated delays in securing approval for investment deals. Most recently, in early 2008 the government began to revise the 2006 mining law. The original law had been broadly welcomed, although it raised the royalty rate from 2.5% to 5% and removed some tax holidays, as it contained improvements such as allowing longer contracts and guaranteeing stable tax regimes. The government re-examined aspects of the law, with, among other things, a view to allowing the state to take a higher stake in large-scale mining projects that it deems to be strategically important. However, it failed to pass the amendments before the election, leaving this task to the new government. In late 2008, with the economy deteriorating, the government was under renewed pressure to finalise an investment deal for the massive Oyu Tolgoi mine. Nevertheless, in view of the political sensitivities involved (no party will want to be accused of having given over-generous terms to foreign investors), these agreements may still face delays.

The government will also face pressure to tackle corruption. The bumpy transition since the early 1990s from a centrally planned economy to a market system has created significant opportunities for graft, particularly in the lower ranks of public office.

Economic forecast

Economic growth

Real GDP growth reached 9.9% in 2007, accelerated to 10.2% year on year in the first quarter of 2008 and again to 11.3% in the second quarter. However, Mongolia's economic outlook has deteriorated significantly in recent months, primarily due to the sharp slide in copper and gold prices, which will significantly reduce export earnings. From an average of US$3.16/lb in 2008, the Economist Intelligence Unit expects copper prices to fall to just US$1.58/lb in 2009. Gold prices will also fall this year, but less sharply. We now expect growth in China (Mongolia's main export market) to slow to only 6% in 2009, after posting double-digit growth for most of the past five years. Although Mongolia's interest rates may come down further, credit has tightened as banks have become increasingly reluctant to lend. This, combined with slowing growth and a probable rise in unemployment, will result in a dampening of Mongolia's private investment and consumption growth in 2009. House prices and the stockmarket tumbled in late 2008, which will further reduce consumer confidence and consumption in 2009.

Given the deterioration in the external and domestic environment, we have revised down our forecast for real GDP growth this year, to 6%, before picking up in 2010 as commodity prices begin to recover. The upturn could be reasonably strong, provided that the new government can resolve outstanding mining investment deals, allowing the sector to benefit from strong FDI inflows. However, the recent deterioration in the economy has highlighted the problems caused by Mongolia's narrow tax and export base (dominated by copper and gold), which leaves export earnings and government revenue exposed to fluctuations in global commodity prices. Given that the budget deficit is rising sharply and foreign-exchange reserves are dwindling, several ratings agencies have downgraded the outlook for Mongolia's long-term sovereign debt in late 2008 and early 2009. As growth is also slowing sharply, the risk remains of further shocks to the banking sector. The government has acted swiftly by introducing a bailout package, but this has resulted in a sharp rise in government liabilities.

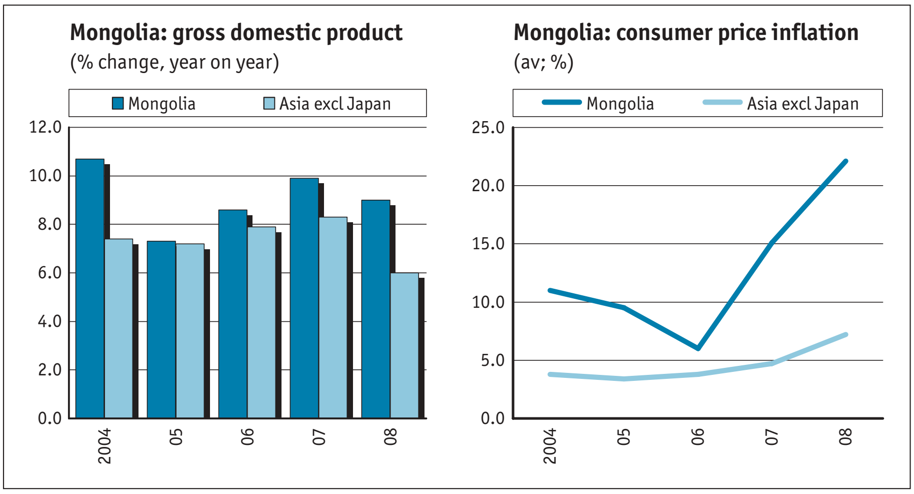
Continued development of the mining sector and a respectable overall economic performance depends on the maintenance of a policy environment conducive to foreign investment. In 2007 the government sent mixed signals to foreign investors in the mining sector. In August parliament voted to retain the controversial "windfall" tax, which had been passed into law at short notice in May 2006. The tax targets copper and gold producers, which had been enjoying bumper profits as a result of high international prices. In early 2008 parliament began to review the 2006 mining law. The expectation was that major investment deals, including the agreement with Ivanhoe Mines of Canada for the development of the Oyu Tolgoi copper and gold mine, would remain on hold while the law was reviewed. However, in late 2008 parliament voted to allow the government to seek an investment deal for Oyu Tolgoi without waiting for the revision to the legislation. Once the Oyu Tolgoi site goes into production, it will give a major boost to industrial production and exports. However, repeated delays in approving a final deal have already postponed the start of production until at least 2011.

Mongolia was hit by surging global prices for energy and foodstuffs in 2008, bringing a surge in inflation. Consumer price inflation ended 2007 at over 15% year on year. Since then, rising transport costs and high food prices have pushed up the inflation rate further, to a peak of 33.7% year on year in August. However, the slump in global commodity prices and weakening domestic demand have started to have an impact. Consumer price inflation slowed to 22.1% year on year in December, although level was still uncomfortably high. We have revised down our forecast for crude oil prices. We now expect oil prices to fall to an average of just US$35/barrel in 2009, before rising to US$50/b, in 2010. We also expect prices for key foodstuffs, including wheat and rice, to slide in 2009. These factors will reduce import price pressures at a time when domestic demand is also weakening, suggesting that inflation will come down this year.

External sector

There has been a marked deterioration in Mongolia's external accounts in recent months. The rising cost of energy imports tipped the merchandise trade account back into deficit in 2007. (Mongolia is heavily dependent on imports, mainly from Russia, to meet its fuel needs.) Record global oil prices accelerated this trend in the first nine months of 2008, when surging imports outstripped exports. Energy prices fell in late 2008, as did the prices for Mongolia's main exports—copper and gold. As a result, Mongolia's merchandise trade deficit leapt to US$1.1bn in 2008, from just US$228m in the previous year. The trade position is likely to deteriorate further in 2009. Export growth will level off, owing to a sharp slowdown in real GDP growth in China, which absorbs the bulk of Mongolia's exports, and a continued fall in global copper and gold prices. This will dent export earnings until production increases strongly, which will not occur without government approval for several major investment deals. Development of the Oyu Tolgoi copper and gold site will give a significant lift to export earnings once the project comes on stream, but delays in granting parliamentary approval mean that this will not happen in the forecast period. The merchandise trade deficit is therefore set to widen further, although weaker domestic demand and falling global oil prices will help to curb imports.

The deteriorating merchandise trade position has already pushed the current account back into deficit. In the first half of 2008 the current-account deficit totalled US$364.5m, compared with a surplus of US$75.8m for the whole of 2007. This has, in turn, eroded Mongolia's foreign-exchange reserves. According to national estimates, net international reserves dipped to US$637m at end-2008, from US$975m at end-2007. The external position should continue to be supported to some extent by robust FDI inflows, provided key mining deals can be approved, as well as by the provision of aid and credit on concessional terms. However, the bailout of the banks in late 2008 has forced the government to look for large new loans (it has approached both the IMF and China), which will significantly increase the government's levels of external debt.



The political scene

The government tackles the deepening economic crisis

Mongolia's ruling coalition, appointed in late August, has faced a difficult few months. The coalition, which brings together the Mongolian People's Revolutionary Party (MPRP) and the Democratic Party (DP), did not have a promising start. The MPRP won the national election, held in late June, but the DP contested the result, culminating in violent riots by pro-DP supporters in the capital, Ulaanbaatar, in early July. After weeks of stalemate the DP finally agreed to form a coalition government in order to restore stability. Within weeks, the new coalition had to deal with a sharply deteriorating economy as the global financial crisis hit Mongolia, forcing the government to announce a bailout package for the country's commercial banks in late November.

The MPRP-DP coalition was only ever a marriage of convenience, and the difficult economic conditions of the past few months have strained relations between the two parties. The government has had to amend budget plans for

2009, partly owing to the sharp fall in tax revenue from the mining sector, as copper and gold prices have tumbled. This forced the MPRP and the DP to consider cuts to monthly child support payments and other social programmes. For now, the government has maintained much of its social welfare spending; however, if the government were forced to make cuts, the DP's support for the coalition could be tested.

At the end of December the governor of the Bank of Mongola (BOM, the central bank), Alag Batsukh, unexpectedly resigned, stating that he wanted to "uphold the independence" of the bank. He was replaced by L Purevdorj, who has held a variety of government posts including leading the privatisation committee. Mr Batsukh hinted in an interview that he had faced political "resistance" to the bank's recent efforts to shore up the banking system and stem the slide in the exchange rate. While many MPs have remained supportive of the BOM's efforts to stabilise the economy, Mr Batsukh clearly felt that he had lost the support that he required. The head of the Financial Regulatory Committee, D Bayarsaikhan, also resigned over criticism of the crisis sweeping the banking sector.

A presidential election is looming

The date for Mongolia's next presidential election has been set for May 24th, with campaigning set to begin in late March. The election is expected to be a tight race between the candidates of the MPRP and the DP, the two parties that dominate Mongolia's parliament, the State Great Khural. The incumbent president, the MPRP's Nambaryn Enkhbayar, may be selected by his party to run for a second four-year term. The DP is likely to announce its candidate after the party congress, scheduled for mid-April.

The dispute over the result of the June national election has rumbled on. In January the chair of the General Election Commission (GEC), B Battulga, and the GEC secretary, D Bayarsaikhan, were sacked. N Luvsanjav was appointed as the new head of the GEC, while Ch Sodnomtseren, a former minister of agriculture, was appointed as his deputy. Mr Battulga was apparently dismissed because a re-run of elections for several seats with disputed results had taken more than six months, with the result for one seat still undeclared. The upcoming presidential election is likely to prove to be a challenge for the GEC, which must restore its battered reputation. Any dispute over the result of the presidential election is also likely to strain the MPRP-DP coalition; many within the DP remain unhappy with the June national election result, and some factions do not support the party's decision to form a coalition with the MPRP, believing that the party should have continued to campaign for the election result to be overturned.

Economic policy

The government tries to avert a banking crisis

The deterioration in the global economy has placed considerable strain on Mongolia. The collapse in commodity prices, particularly for copper, has hit export earnings and government revenue. Amid slowing domestic growth in late 2008, fears emerged that Mongolia's banks, which have been big lenders in recent years, had overextended themselves. The Bank of Mongolia (BOM, the central bank) insisted that strong fundamentals, including high capital adequacy ratios of 14% and declining non-performing loans, would protect the banks. However, recent years have seen very strong growth in loans, much of it short term and to sectors such as construction, which have been hit by the recent economic downturn. At the same time, high inflation (which reached 22.1% year on year in December) has curbed growth in deposits.

Against this background, rumours began to circulate in the final quarter of 2008 that some banks were suffering as nervous depositors rushed to withdraw funds. The crunch finally came in November when regulators took over one of the top five lenders, Anod Bank; several board members were detained amid fears that the bank's loans were higher than reported. On November 25th the government announced that all deposits at the country's commercial banks would be guaranteed for three years, in an effort to shore up confidence. In a further effort to stabilise the situation, in mid-December parliament approved a Tg455.1bn (US$389m) bailout package for the banks. Despite these efforts, concerns have remained over the stability of the banking sector. Also in mid-December an international ratings agency, Moody's Investors Service, stated that the ratings of Xac Bank had been placed on review, with the possibility of a downgrade. Some of the ratings of Khan Bank were changed from a stable to a negative outlook. In late January another ratings agency, Fitch, downgraded its ratings for both banks, from B+ to B, with the outlook remaining negative.

In mid-January the government set up a working group led by the prime minister, Sanjaagiin Bayar, to tackle the crisis. The government also sought external funding to aid its stabilisation efforts, holding talks with both the IMF and China. The government was apparently discussing a huge US$3bn loan from China, US$1bn of which would be used to support the banking system. The government was also considering placing its first sovereign bond offering in early 2009—although downgrades to its ratings may delay this.

Budget deficit to rise due to deteriorating economy

According to preliminary figures from Mongolia's National Statistical Office, total government revenue in 2008 stood at Tg2.2trn (US$1.8bn), while total expenditure (including net lending) amounted to Tg2.5trn, leaving a deficit of Tg305.7bn, or 5% of GDP, which was around double the government's target level. In recent years Mongolia has posted consistent budget surpluses, thanks in part to strong revenue from the "windfall" tax on copper and gold mining, which has more than offset heavy government spending on wage increases and social welfare programmes. However, the sharp fall in the price of copper in the final months of 2008 has eroded government revenue.

The domestic economy

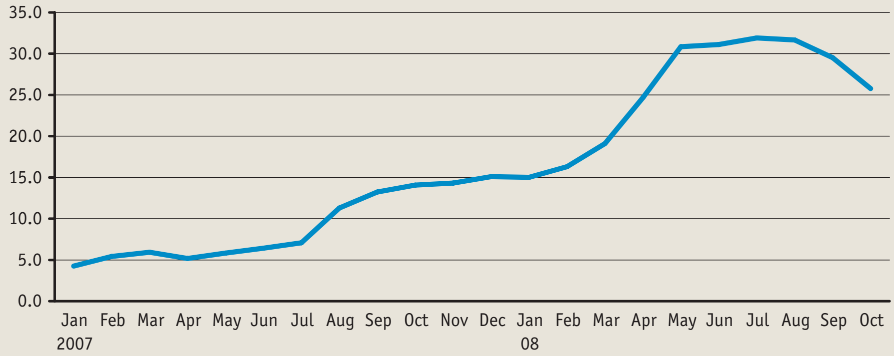
Real GDP growth has started to slow

In the first half of 2008, the economy appeared to be in danger of overheating, owing to strong external and domestic demand, high commodity prices, an expansionary fiscal policy, rising wages and rapid loan growth. According to the World Bank, real GDP growth accelerated to 11.3% year on year for the second quarter of 2008, from 10.2% in the first quarter of the year. That position changed rapidly in the final months of 2008, as the global financial crisis started to bite. Prices for copper, Mongolia's main export, fell sharply, hitting export earnings and government revenue. An overextended banking sector began to suffer in the second half of the year, resulting in a marked tightening of domestic credit, further slowing overall economic growth. According to data from the National Statistical Office (NSO), industrial production rose by only 2.8% year on year in 2008 in constant price terms. The government had originally forecast real GDP growth of over 14% for 2009. This has been revised down to 9.6%, which still appears to be overly ambitious.

Inflationary pressures ease in late 2008

Consumer price inflation rose in the first three quarters of 2008. According to the NSO, consumer price inflation averaged 28% for the year as a whole, up from 9% in 2007, and 5% in 2006. Inflation was driven by a number of factors, including strong domestic demand following several rounds of wage increases, which pushed up the prices of many consumer items, as well as import price pressures, particularly for food and fuel. However, tightening credit and slowing economic growth in late 2008 saw an easing of inflationary pressure. Consumer price inflation eased to 22.1% year on year in December, from a high of 33.7% year on year in August.

Mongolia: inflation
(% change, year on year)



Source: IMF.

Mining

The Oyu Tolgoi investment agreement is still not finalised

The government has promised to finalise an investment agreement with a Canadian firm, Ivanhoe Mines, to allow the long-delayed Oyu Tolgoi copper-mining project to get off the ground. Located close to the border with China, the Oyu Tolgoi site contains estimated reserves of 32m tonnes of copper and almost 990 tonnes of gold. Development of the mine has faced repeated delays. A draft investment agreement was reached in early 2007, but was never approved by parliament, amid growing public demand for the government to take a larger stake in Oyu Tolgoi and other "strategic" mining projects. However, by late 2008 the government was under renewed pressure to finalise a deal; development of the multi-billion-dollar mine would give a major boost to the economy at a time of slowing growth. In December the State Great Khural (parliament) voted by 42 to 8 to authorise the government to negotiate a new investment agreement and to present this back to parliament by February 1st, when it was due to close. Yet again, however, the deadline was missed. Instead, the government promised to hold an extraordinary session of parliament in mid-February to review the draft agreement.

There is no doubt that Ivanhoe wants to see the project approved—it has already invested heavily in developing the remote site. However, even if the agreement is finalised soon, the project could still face delays. In late 2008 Ivanhoe announced plans to cut jobs as well as spending on development work at the mine, owing to the global downturn and falling copper prices.

In a further move to encourage investment in the mining sector, in November the government announced plans to amend the unpopular "windfall" profits tax. The tax will now not come into force until the price of gold reaches above US$850/oz, from the previous level of US$500/oz. The government claimed that instead of generating higher revenue, the tax had resulted in a rise in smuggling and tax avoidance.

Foreign trade and payments

The trade deficit widens sharply

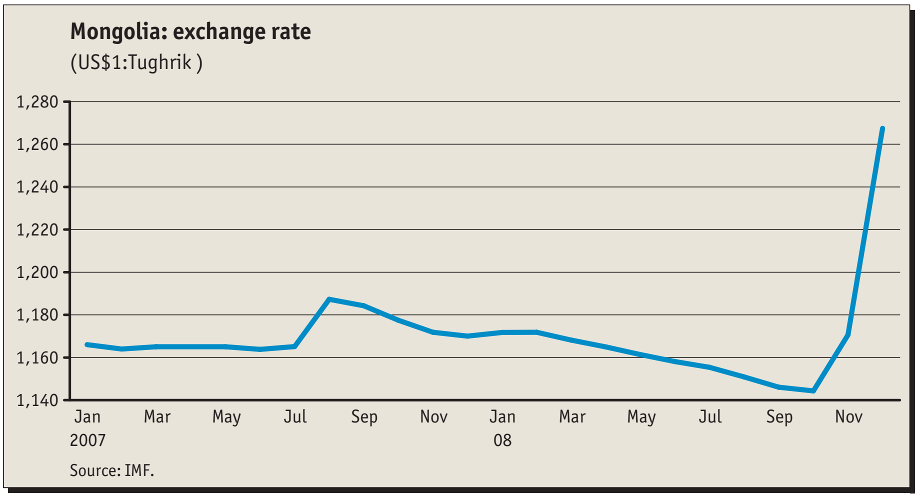
According to the National Statistical Office, the merchandise trade deficit widened sharply in 2008, reaching almost US$1.1bn, compared with a deficit of just US$228.3m in 2007. Exports managed growth of 30.3% year on year, boosted by strong prices for copper and gold (Mongolia's main export commodities) in the first three quarters of the year (before copper prices collapsed in the fourth quarter). However, imports leapt by 66.6% year on year, driven by the high costs of food and fuel imports (Mongolia is heavily reliant on imported oil products from Russia and food items from China). Strong demand for machinery and equipment by foreign-funded mining ventures also helped to drive up imports.

Mongolia: foreign trade
(US$ m)

	2007	2008
Exports	1,949.0	2,539.3
Imports	2,170.0	3,615.8
Trade balance	**-228.3**	**1,076.5**

Source: Bank of Mongolia, *Monthly Bulletin;* National Statistical Office, *Economic and Social Situation of Mongolia*.

National estimates suggest that the deterioration in the merchandise trade deficit in recent months has resulted in a rapid erosion of Mongolia's net international reserves, which dipped to US$637m at end-2008, from US$975m at end-2007. The fall was the result of increased downward pressure on the value of the togrog in the final months of 2008, and government intervention to support the currency. The togrog ended the year at Tg1,267.5:US$1, from Tg1,170:US$1 at end-2007.



Mongolia: foreign reserves
(US$ m; end-period)

	2006 Year	2007 Year	2008 1 Qtr
Foreign-exchange reserves	926	1,196	1,156
SDRs	0	0	0
Gold	135	199	158
Total	**1,061**	**1,395**	**1,314**

Source: IMF, *International Financial Statistics*.